A Comprehensive Study on Venture Capital and Private Equity Markets in India

A Synopsis

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1. Introduction:

Venture capitalism a significant financial innovation in the twentieth century. It has also been described as 'unsecured risk financing'. The relatively high risk of venture capital is compensated by the possibility of high returns usually through substantial capital gains in the medium term. Venture Capital in broader sense is not solely an injection of funds into a new firm but it is also an input of skills needed to set up the firm, design its marketing strategy, organize and manage it. The term Venture Capital comprises of two words that is "Venture and Capital". **"Venture"** is a course of processing the outcome of which is uncertain but to which is attended the "risk" or danger of "loss". **"Capital"** means recourses to start an enterprise. To connote the risk and adventure of such a fund, the generic name Venture Capital was coined.

Over the last two decades, the Venture Capital and Private Equity (PE) industry has emerged as an important area of finance and has attracted the attention of academic researchers and practitioners' aside. In addition, the VC industry had experienced several boom and burst cycles but nothing of the magnitude of the tech bubble. Annual venture investing soared from under $10 billion in mid 1990s to over $100 billion in 2000 before plunging down to earth after the tech bubble burst **(Green 2004)**. This bubble is thought to have altered the investment patterns of the VC industry. Venture Capital funding is an increasingly important source for entrepreneurial ventures in both industrialized and developing countries. Venture capital financing has become especially important in India in developing information technology sector **(NASSCOM 2000)**. Venture capitalists ("VCs") invest in small private growth companies that typically do not have cash flows to pay interest on debt or dividends on equity. They receive capital from institutional investors (particularly pension funds), high net worth individuals and invest the deposits in entrepreneur firm (EF) over a period that generally ranges from two to seven years prior to exit. Both-VC and PE employ a proactive origination strategy that have consistently higher returns, driven by greater quantity and higher relevance of incoming investment opportunities.

Among developing countries, India has a big role in VC industry. The VC industry started here in 1964, although it has been formally recognized under developed markets like of the US since 1940's. Prior to Pre-globalization, India witnessed a very slow growth but after 1991, India experienced tremendous growth in the number of deals, total investments, deals size etc. India saw the largest increase in deal activity among the big Asia-Pacific markets in 2010. Although still far below the 2007 peak of US $17 billion, last year's total

deal values more than double from that of 2009 to US $9.5 billion including venture capital, infrastructure PE investments and real estate investments.

Venture capital in India has been in receipt of governmental impetus over several decades. According to (**PANDEY 1998)**, the structural changes in the legal and tax systems along with improvement in general economic conditions have propelled India into the foreground of international venture capital and private equity markets. According to Price Waterhouse Coopers (PWC) Global private Equity report 2008, India was the recipient of highest PE-VC report investments in Asia –Pacific Region and is only behind from US and UK worldwide. India had moved from 14th rank with a share of only 1.5% in 2004 to 3rd rank with a share of 7% in total PE-VC investment worldwide in 2007. Also as per **(Dossani & Kenny 2002)**, Transfer of know-how from leading venture capital markets like the US, has allowed for a steep learning curve.

The market investors consider the PE markets in India to continue to grow and evolve in 2011 and beyond. However short term nervousness in the capital markets in 2011 and high priced corporate debt, kept valuations down. Still healthy macroeconomic condition continues to support India's status as a preferred destination for investors. India's fundamentals will continue to attract eager PE investors and bolster the confidence of limited partners. The pace and strength of the industry's future growth would be accelerated if valuations in India become more attractive and exits continue to build on the momentum established in 2010. Indian promoters are gradually coming to recognise PE as a patient source of active capital that can help builds their businesses. The PE industry will need to work closely with their investor companies and invest in further educating other Indian promoters about the PE and VC value proposition. According to **(India Private Equity Report 2011)**, India's PE and VC industry is far from reaching its full potential. As per report the biggest barrier holding India back is because of lack in the regulatory support. Indian policymakers still do not regard PE and VC as a distinct asset class nor do they give sufficient attention to creating a regulatory environment for more conducive to industry growth thereby still behind the PE markets of United States.

2. Objectives:

The objective of this work is to outline the present status of the venture capital and private equity industry in India and to find the changes that could be effected in the present environment to enable venture capital grow at a fast pace and accelerating the economic growth. The following are the main objectives of the study to assess the role of VC and PE in the promotion of Indian market:

1. The focus of this study will look at the lifecycle of VCPE investments, i.e., from the time of investment in the company till their exit from the investment, as well as areas related to investments such as investment decision making, structure of investments, and valuation.

2. Research will focus on the recent growth phase of the VCPE industry in India that has been limited. Most of the studies have focused the Indian industry were either before the growth phase or did not cover the growth phase in full, starting from the onset of growth till the slowdown, caused by the global financial crisis. This study is an attempt to meet the gap in research on the recent trends in the Indian VCPE industry.

3. To identify the legal framework formulated by SEBI to encourage VC activity in Indian Economy as well as to know the impact of political, economic and geographical factors on VC investments.

4. To suggest measures to streamline the existing structural framework and to identify the future prospects of VC and PE in Indian capital market along with suggesting the ways and means to explore the new arising opportunities.

5. The study will highlight some of the lesser known features of the Indian VCPE industry such as the characteristics of the investee firm at the time of VCPE investment, the duration of VCPE investments in the firm, and the timing and mode of exit by the investors. The objective is to provide a holistic understanding of the Indian VCPE industry to enable the creation of a policy environment to sustain the growth of the industry.

3. Review of Literature:

Venture Capital (VC) is an important source of funding for the development of innovative start-up companies. Yet the finance literature provides little guidance regarding how much the venture capitalist should pay to fund new projects but still the rate at which new entrepreneurs are emerging is very high and even exponential growing. According to **Cossin, Leleux & Saliasi (2002)** valuing early-stage high-technology growth-oriented companies is a challenge to current valuation methodologies. VC projects also vary in terms of the nature of the proposed firm. According to **Hellman & Puri (2000)**, these firms can be split into innovator or imitator firms. The difference is that innovator firms are launching new products and services that have not been offered previously. For imitator firms, such a product or service has been introduced previously and the new firm contends that it can provide this more cost effectively or efficiently.

Although various studies have looked at the theoretical and empirical literature that explores how VCs screen, select, finance, syndicate, monitor and advise their portfolio companies, but as per **Gompers and Wright (2001)**, The behaviour of VC and Entrepreneurial firms in terms of existence is still an unexplored area - despite of its importance for industry survival and economic growth. Moreover little work is done on influence of dot-com effect on Venture Capital Industry.

India has a burgeoning economy and over the past decade it has been receiving tremendous global attention. Growth in emerging markets like India has been propelled by the government taking firm steps towards economic liberalization **HOSKISSON et al (2000)**. Capitalizing on its labour cost advantage, a feature common to emerging economies, India has been able to leap frog from being just another fast developing economy to becoming a major emerging market. According to **De Mattos et al (2002)**, over the next 20 years, India along with China, Brazil, Turkey and Mexico is expected to become an economic centre of the world. With GDP growing at the rate of 8% annually in the past three years **Reddy (2006)** and with the purchasing power of the middle class increasing, there is great demand for products and services. The Telecommunications and Banking sectors have seen tremendous growth along with Information Technology (IT) and Information Technology Enabled Service (ITES) sectors.

As per **Pandey & Rajan (2011)**, VC alleges that the information they breed and the services they provide are as important as funds infused. Hence the monitoring they provide is essential & valuable, which is also associated with some predictions about the firm. Thus

VCs operate in an environment where their relative efficiency in selecting and monitoring investments gives them a comparative advantage over other investors. This suggests strong industry effects in venture capital investments **Amit, James and Zott (1998)**.

An entrepreneurial culture, a legal system that provides protection to the investor, an encouraging government, a labor market rich with engineering talent, a non-penalizing tax regime, and the existence of an IPO Industry for the realization of value are characteristic common to develop venture capital industries like Britain, Switzerland and Israel **Megginson (2001)**. Similarly **Jeng & Wells (2000)** also identify factors that impact venture capital growth highlight non-rigidity of labor market, IPO as an exit route, macro-economic conditions and government programs.

Wang and Sim (2001) conducted an empirical study in Singapore using survey data for the period: 1990-1998. The study concluded that family owned, high technical industries tend to exit via IPO. Moreover IPO exit route is positively related to total amount of venture financing and total sales while being independent of frequency of finance rounds. These results reveal immaturity of Asia's capital market in comparison to west.

Giot and Schwienbacher (2007) examined the time to 'IPO', 'Trade sale' and 'liquidation' for 6000 VC backed firms covering more than 20,000 investment rounds. They concluded that as time flows, likelihood of firm exiting via IPO increases with the time. However after reaching a plateau, non-exited investments have fewer possibilities of IPO exits as time increases. This sharply contrasts with trade-sale exits. The results also indicated that proximity of at least one VC fund makes trade sales more likely.

According to **Bienz and leite (2008)** , highly profitable company that need few insights will go public ,while less profitable company that require more control will be sold in trade-sale. This is consistent with empirical evidence that IPOs have higher rate of return than trade sales. **Schwienbacher (2010)** introduces product characteristics into the analysis with the aim to identify their effect on the optimal exit decision on the financial market. Going public can be more profitable than a trade-sale when the product is sufficiently innovative. **Cumming and Johan (2008)** investigated a sample of 223 entrepreneurial investee firms financed by 35 venture capital funds in 11 continental European countries. The results indicates pre-planned acquisition exits are associated with stronger investor veto and control rights, a greater probability that convertible securities will be used, and a lower probability that common equity will be used; the converse is observed for pre-planned IPOs.

I.M. Pandey (1998) investigates the process of developing venture capital in India through TDICI. In the initial years they face a lot of problems, like in raising funds and

evaluating prospective business. Initially they focused on high-tech industry but later on they shifted to profitable industry. Later on the firms get flourished and took initiatives to develop VC industry in India. **Rajan (2010)** introduced a VC/PE data sample in India for the period 2004-2008 .The results indicates large proportions are round 1 investment with dramatic decrease in subsequent rounds. Most of the investment are late stage and characterize by short duration. These factors don't favors long-term growth of VC industry in India.

4. Methodology

With a view to achieve the objectives of the present study, the secondary sources of information will be utilized. The history, genesis, components, growth, performances etc. of the Venture Capital and Private Equity markets in India have been examined on the basis of secondary data like periodicals, magazines, text books, journals, reports, office records of various organizations like SEBI, RBI and ministry of finance, and different websites containing information and data of Indian Venture Capital Association (IVCA) and the Asian Pacific Equity Bulletin, 2005 to 2013. Thus, research work will heavily bank on the secondary source of information.

4.1 Statistical Tools

Scientific methods of statistics and econometrics will be applied for analyzing the data and getting the results to derive logical conclusions. Besides simple statistics like means, coefficient of variations, correlation coefficients. The research will aim to investigate the investment patterns related to deals as well as firm level in VC industry through One-way ANOVA results, multiple regressions and discriminate analysis to test whether there is any significant difference between the variables over different periods. Generally the null hypothesis is formulated as if there is no significant difference between the variables and the alternate hypothesis is that there is a significant difference between the variables.

4.2 Hypothesis of the study

To study the above mentioned objectives, the following hypotheses are formulated:

HO.1: Null Hypothesis: There is no significant effect on the syndication level and funds participation.

HO.2: Null Hypothesis: There is no significant influence on the investment stage.

HO.3: Null Hypothesis: There is no significant effect on Investment per deal and total requirement by a firm.

HO.4: Null Hypothesis: There is no significant difference in respect to VC and PE play significant role in Indian Economy.

Rejection of any of the above hypotheses will automatically make to accept the alternative hypotheses in each case.

4.3 Significance/Need of the study

Significance of the study will be broader and investigates the influence on Venture Capital Industry, investment patterns comparisons across industries & exit strategies. The study will cover up VC/PE market in terms of VC funds participation and investment as well as focuses on patterns in different industries and the dotcom influence. Dot-com has a significant influence on time taken by a firm from its first funding to get exit. The time period is ranges from 2005 to 2013 and produces a picture of exact impact of VC industry, marked a historical peak in terms of capital volume and valuations. The study critically evaluates the role of Venture Capitalists in the Indian VC market. Moreover the purposes of the study are to find factors relevant to particular made of exit.

It will also investigate development of private equity activities in recent years, with the growth of local funds and the arrival of global players, and how Private equity firms need to position themselves as partners. The study would also be helpful for further descriptive studies on the ideas that will be explored. Therefore, the present study is quite beneficial to gain knowledge regarding VC/PE investments, and their role and impact on the promotion of Indian VC/PE market.

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